STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Apple Canyon Utility Company	)	
	)	
Lake Wildwood Utilities Corp.	)	
	)	
	)	Docket Nos. 12-0603, 12-0604
Proposed general rate increase for	)	(Cons.)
water service.	)	
	)	

INITIAL BRIEF OF THE
STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Counsel for the Staff of the
Illinois Commerce Commission

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INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

The Staff of the Illinois Commerce Commission ("Staff"), by and through its counsel, and pursuant to Section 200.800 of the Illinois Commerce Commission's ("Commission" or "ICC") Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Initial Brief in the above-captioned matter.

Introduction

On October 1, 2012, Apple Canyon Utility Company ("AC" or "Apple Canyon") and Lake Wildwood Utilities Corp. ("LW" or "Lake Wildwood") (collectively, the "Companies") filed separate 285 Filings and separate direct testimony of Mr. Dimitry Neyzelman, which proposed general rate increases for the respective water services. On November 8, 2012, the Commission suspended both proposed tariffs to and including January 28, 2013. On November 13, 2012, Lake Wildwood Association, Inc. ("LWA") filed a petition to intervene in Docket No. 12-0604. On December 3, 2012, the People of the State of Illinois ("AG") filed an appearance in both dockets, and Docket Nos. 12-0603 and 12-0604 were consolidated. On December 17, 2012, the Companies filed a Motion for Entry of a Protective Order in the consolidated proceeding, which was granted on April 15, 2013. On January 22, 2013, Apple Canyon Lake Property Owners' Association ("ACLPOA") filed a verified petition to intervene. On January 22, 2013, the direct testimony of Staff was filed, and the AG and LWA/ACLPOA filed separate motions to extend time to file direct testimony, which were granted. On January 24, 2013, the Administrative Law Judge ("ALJ") issued an Amendatory Order which stated the suspension date of January 28, 2013 was incorrect and the tariffs should have been suspended until February 27, 2013; the Commission's order was amended to make this correction. On January 25, 2013, Staff filed an errata correcting schedules attached to Staff's direct testimony. On January 28, 2013, ACLPOA and LWA separately filed direct testimony, and ACLPOA, LWA, and AG jointly filed direct testimony. On February 21, 2013, the Commission re-suspended the tariffs to and including August 27, 2013. On February 26, 2013, the Companies filed rebuttal testimony. On March 21, 2013, a public forum was held to receive public comment on the proposed general rate increase of water service. On March 26, 2013, Staff, LWA, and AG/LWA/ACLPOA separately filed rebuttal testimony. Staff filed an errata on April 5, 2013 correcting a schedule attached to Staff rebuttal testimony. On April 9, 2013, the Companies filed surrebuttal testimony. On April 15 and 16, 2013, an evidentiary hearing was held. Pursuant to the schedule set by the ALJ, Staff now files its Initial Brief ("IB") in the above-captioned proceeding.

Discussion

I. REVENUE REQUIREMENT

The revenue requirement schedules attached to Staff's IB (Appendices A and B) use Staff's rebuttal revenue requirements as their starting point. To the extent that Staff accepted the Companies' surrebuttal position on an issue, Staff reflects that position in the attached revenue requirements.

a. Apple Canyon

Staff recommends a revenue requirement of $534,620, as reflected on page 1 of Appendix A to Staff's IB.

Staff recommends an overall increase to revenues of $68,985 (14.82%), which is $31,344 less than the $100,329 increase requested by the Company in rebuttal and surrebuttal.

Staff recommends a rate base of $950,027, as reflected on page 3 of Appendix A to Staff's IB. Staff's recommendation is $3,424 more than the $946,603 rate base requested by the Company in rebuttal and surrebuttal.

b. Lake Wildwood

Staff recommends a revenue requirement of $417,122, as reflected on page 1 of Appendix B to Staff's IB.

Staff recommends an overall increase to revenues of $101,746 (32.26%), which is $23,506 less than the $125,251 increase requested by the Company in rebuttal and surrebuttal.

Staff recommends a rate base of $993,929, as reflected on page 3 of Appendix B to Staff's IB. Staff's recommendation is $1,834 more than the $992,095 rate base requested by the Company in rebuttal and surrebuttal.

II. RATE BASE -- ADJUSTMENTS

Uncontested Issues

Prior Plant Disallowances

Staff witness Ebrey proposed adjustments to reflect disallowances of plant in service that had been disallowed in prior Apple Canyon and Lake Wildwood rate cases. For Apple Canyon, Docket Nos. 03-0398 through 03-0402 (Cons.) ("2003 Order"), Staff proposed a correction to the Company's calculation of accumulated depreciation that was not considered in the adjustment to remove plant from the Company's books. In addition, Staff proposed an adjustment to recalculate the accumulated depreciation associated with the plant disallowed in Docket Nos. 90-0475/92-0402 (Cons). The Company accepted these adjustments in rebuttal testimony. Utilities Ex. 2.0 at 3.

For Lake Wildwood, Staff proposed an adjustment to remove plant that was disallowed in the original cost determination case, Docket Nos. 90-0476/92-0402(Cons). In addition, Staff proposed an adjustment to remove plant disallowed in Docket No. 01-0663. In rebuttal testimony, the Company accepted Staff's proposed adjustment for the original cost case disallowances, but explained that it had removed the plant disallowed in Docket No. 01-0663 erroneously from its books. *Id.* The Company proposed a different adjustment for that plant which Staff accepted in rebuttal testimony. Staff Ex. 8.0 at 3.

Accumulated Deferred Income Taxes

Staff proposed a methodology used in prior Utilities' Inc. ("UI") rate cases to adjust accumulated deferred income taxes to reflect changes in depreciation expense adjustments to the revenue requirement. While the Companies did not agree to all adjustments proposed in the case for depreciation expense, the Companies did agree with the methodology and that the final revenue requirement should reflect the depreciation expense, and therefore the adjusted accumulated deferred income taxes, ultimately approved in this case. Utilities Ex. 2.0 at 9.

Contested Issues

Cash Working Capital

Staff proposed an adjustment to remove the impact of real estate taxes where payment is deferred for more than a year from the calculation of cash working capital ("CWC"). The Companies accepted Staff's adjustments. Utilities Ex. 2.0 at 2. The AG, however, proposed to also adjust the calculation to omit all Taxes Other Than Income from the calculation based on the formula method. AG/ACLPO/LWA Joint Ex. 1.0 at 9. In rebuttal testimony, the Companies argued that the Commission has routinely allowed taxes other than income in the CWC calculation, with the only exception being the real estate tax expense proposed by Staff. The Companies provided an extensive list of cases that support its claim. Utilities Ex. 2.0 at 2-3. Staff agrees with the Companies that it should be allowed to include taxes other than income in its CWC calculation. Staff Ex. 8.0 at 2.

Leak and Boundary Surveys

Staff agrees with the AG proposal to remove the costs associated with leak and boundary surveys from rate base in these rate cases. The Companies argue that the surveys should be capitalized according to Uniform System of Accounts ("USOA") Accounting Instruction 19; however, Accounting Instruction 19 states that the subject survey is "applicable to construction work." According to the description of Account 183, Preliminary Survey and Investigation Charges, the costs of surveys may be deferred pending the feasibility of projects under contemplation, however, utility plant accounts would only be charged in the event a construction project results. From Staff's analysis and review of the USOA, if a survey is not associated with specific construction projects, it should be recorded to expense accounts. Staff Ex. 8.0 at 4-5.

The Companiesadmit that they did not provide support for the specific capital assets tied to the leak survey; therefore, there is no record evidence to support their inclusion in rate base. Utilities Ex. 3.0 at 4. The Companies cite to specific cases in surrebuttal testimony to indicate that the boundary surveys were associated with specific expansion of the respective Company's service area. *Id.* However, the Orders in those dockets clearly state that Apple Canyon and Lake Wildwood would incur no costs associated with those expansions:

> Because the Fire Protection District assumed responsibility to pay for the cost associated with the construction of the facilities necessary to connect to the water system, **the Petitioner would incur no direct costs** to extend its service area.

Final Order at 3, Docket No. 10-0215 (October 20, 2012) (emphasis added). And

> The Fire Protection District was responsible to pay all costs associated with construction of the water service line so that **Apple Canyon will incur no costs**.

Final Order at 4, Docket No. 10-0215 (October 20, 2012) (emphasis added). And

> According to Mr. Daniel, the customers were willing to install service lines at their own expense to connect to the Company's mains at points within the existing service area. **No additional construction or facilities were required to serve the eight customers located in the proposed service area.** Because the Company was not extending its mains or constructing any facilities outside its service area, it believed a certificate was not required.

Final Order at 2, Docket No. 10-0224 (December 15, 2010) (emphasis added). Therefore, the Commission should accept Staff's and the AG's adjustments to remove the cost of the surveys from rate base for both utilities.

Tank Painting

Staff recommends the Commission accept Apple Canyon's proposal to include in rate base the 10-year amortization of tank painting to be completed in May 2013, since adequate support has been provided during the case. Staff Ex. 8.0 at 2. The AG, however, argues that the tank painting should be disallowed from the revenue requirement. AG/ACLPO/LWA Joint Ex. 2.0 at 9. The AG argues that since the evidence to support the tank painting comes after the initial filing, as provided for in Section 287.40, it should be disallowed in this case. However, it is not unusual for the actual documentation to support plant additions to be provided in response to discovery as was done in this case. The only argument regarding the dollar amount of the proposed increase relates to the logo to be painted on the tank. But as Ms. Ramas notes in her testimony, the cost associated with the logo painting is $5,000 out of the $109,670 bid the Company accepted for the job. *Id.* at 12; Utilities Ex. 3.0 at 5. Since the Apple Canyon did not change the original amount requested for the tank painting of $100,000, the AG's argument falls short. Utilities Ex. 3.0 at 5.

Additional Pro Forma Plant Additions

Staff does not take issue with the pro forma plant additions proposed by the Companies in rebuttal testimony for Apple Canyon and Lake Wildwood. Staff witness Thomas Q. Smith reviewed the support for the plant additions and did not find reason to take issue with the additions. Staff Ex. 11.0 at 1-3. The AG, however, argued that the plant should not be allowed for recovery in these cases. AG/ACLPO/LWA Joint Ex. 2.0 at 6-9. Since these projects either have been or will be completed within the time period necessary to be included as *pro forma* plant additions in these cases, and the additions are required for the utilities to continue providing safe, reliable service, Staff recommends the *pro forma* plant additions be approved for inclusion in rate base in these cases.

III. OPERATING REVENUES AND EXPENSES -- ADJUSTMENTS

Uncontested Issues

Depreciation

Staff agreed with the AG that the depreciation rates for Vehicles and Computer equipment should be revised. The Companies agreed in response to Staff discovery that the depreciation rate for vehicles should be set at 20%. Staff Ex. 8.0 at 5. The Companies proposed an adjustment to depreciation expense and accumulated depreciation for computer equipment in response to Staff DR TEE 7.02. Staff accepted those adjustments in rebuttal testimony. *Id.* at 5-6. The AG likewise accepted those same adjustments. AG/ACLPO/LWA Joint Ex. 3.0 at 6.

Incentive Compensation

Staff proposed adjustments for each utility to remove incentive compensation costs from operating expenses. Staff argued that the incentive compensation costs had not been shown to be related to activities that provide customer benefits, but rather, appeared to be entirely for stockholder or employee benefit and related to activities that are tied to net income, cash flow, return on investment, or other activities that should otherwise be provide by the utilities during the regular course of business. Staff Ex. 3.0

at 3-7. However, in rebuttal testimony, the Companies stated that due to recent actions taken by the Companies' parent, UI, the Companies no longer have an incentive compensation plan. The Companies discontinued their incentive compensation plan and returned to a practice of providing a non-elective Company contribution to employees' retirement plans. Utilities Ex. 2.0 at 10-11. As such, Staff withdrew its adjustment. Staff Ex. 9.0 at 3.

Cap-time

Staff proposed adjustments for each utility to reflect the 3% salary increase in the Companies' pro forma adjustment for capitalized time ("Cap Time"). This adjustment decreased operating expenses by an amount 3% higher than the Companies' adjustment. Staff Ex. 3.0 at 7-9. No party took exception to Staff's adjustments. The Companies agree with the adjustments proposed by Staff. Utilities Ex. 2.0 at 11.

Rate Case Expense

Section 9-229 of the Act states:

> The Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. This issue shall be expressly addressed in the Commission's final order.

220 ILCS 5/9-229.

Staff proposed adjustments to (1) remove legal fees from rate case expense that had not been adequately supported; (2) reduce Water Service Company ("WSC") personnel costs included in rate case expense to amounts more consistent with the supporting documentation submitted; (3) remove from rate case expense external consulting fees which had not been adequately supported; and (4) correct the amortization of the rate case expenses previously approved by the Commission in the Companies' prior rate cases, Docket Nos. 09-0540/09-0541 (Cons.) ("2009 rate cases"). Staff Ex. 3.0 at 12-15. In rebuttal testimony, the Companies accepted Staff's adjustment to correct the amortization of the rate case expenses previously approved by the Commission in the Companies' 2009 rate cases surrebuttal testimony, and refined the amount requested for WSC personnel costs. Utilities Ex. 2.0 at 13. In surrebuttal testimony, the Companies accepted, for purposes of this proceeding, the Staff and Intervenor adjustments to remove specific external consulting fees, and further refined the amounts requested for WSC personnel costs. Utilities Ex. 3.0 at 10-11. Further, the Companies provided for the evidentiary record documentation in support of legal fees and in support of all other rate case expenses for which they are seeking recovery. Utilities Ex. 3.3 (Confidential). Staff agrees with the amount of rate case expense set forth by the Companies in their surrebuttal testimony, Apple Canyon Ex. 3.0, Schedule 3.1 AC, Page 11, and in Lake Wildwood Ex. 3.0, Schedule 3.1 LW, Page 11.[1] The revised rate case expense is reflected in Staff's current revenue requirements, attached hereto as Appendix A for Apple Canyon and Appendix B for Lake Wildwood.

Staff recommends that the Order in this proceeding express a Commission conclusion as follows:

> The Commission has considered the costs expended by the Companies to compensate attorneys and technical experts to prepare and litigate these rate case proceedings and assesses that the amounts included as rate case expense in the revenue

[1] In rebuttal testimony, the Companies provided for the evidentiary record the documentation which supports the rate case expense amounts set forth by the Companies and accepted by Staff. The entirety of that documentation was admitted into the evidentiary record as Utilities Exhibit 3.3 (Confidential). Utilities Exhibit 3.3 (Confidential) includes copies of the Companies' responses to Staff DRs on which Staff relied in reaching its recommendation regarding rate case expense.

requirements of $23,240 and $22,882 for Apple Canyon and Lake Wildwood, respectively, are just and reasonable.

Cost of Unaccounted-for Water

Staff proposed adjustments for each utility to decrease maintenance expenses because the unaccounted-for water percentages experienced in the test year exceeded the maximum allowable amounts as defined in the Companies' tariffs. Staff Ex. 3.0 at 15-16. Intervenors set forth similar adjustments. AG/AGACLPOA/LWA Joint Ex. 1.0 at 32-35. The Companies did not oppose the Staff and Intervenor adjustments; however, the Companies chose to adopt the Intervenor adjustments due to an error observed in Staff's calculations. Utilities Ex. 2.0 at 13-14. Staff agrees that the Companies correctly adopted the Intervenor Adjustment. Staff Ex. 9.0 at 2.

Add-On Taxes

Staff proposed adjustments for each utility to reduce operating expenses for public utility taxes included in the Companies' *pro forma* present revenue requirements. The taxes, which are an add-on charge to customers' bills, are not an actual operating expense of the utility and should not be included in tariffed rates. Staff Ex. 3.0 at 16. No party took exception to Staff's adjustments. The Companies agree with Staff's adjustments. Utilities Ex. 2.0 at 14.

New Customer Charge

Staff proposed adjustments for each utility to move revenue associated with the New Customer Charge from Water Service Revenues to Miscellaneous Revenues. Staff Ex. 3.0 at 16. See discussion of New Customer Charge in Section XI below. Intervenors proposed a similar adjustment. AG/ACLPOA/LWA Joint Ex. 1.0 at 24-25. The Companies stated that they agreed with the Staff and Intervenor adjustments.

Utilities Ex. 2.0 at 10. However, the Intervenors took issue with the way the Companies reflected the agreed-to adjustments in their rebuttal exhibits, arguing that the Companies' methodology negates the agreed-to adjustment. AG/ACLPOA/LWA Joint Ex. 2.0 at 2-4. The Intervenors' concerns regarding this adjustment should be dismissed, as those concerns are based on what appears to be a misunderstanding of the mechanics of Staff's revenue requirement.

Staff's revenue requirement is designed to reflect a bottom-up approach starting with the approved Overall Rate of Return and approved Rate Base, and working up to the Total Operating Revenue and Water Service Revenues. Although not obvious from the complex formulas contained within its inner-workings, Staff's revenue requirement essentially calculates Water Service Revenues in the following, bottom-up manner: (1) Approved Overall Rate of Return is multiplied by approved Rate Base to determine Net Operating Income; (2) Net Operating Income is added to Total Operating Expenses to determine Total Operating Revenue; and (3) Total Operating Revenue is reduced by Miscellaneous Revenues to determine Water Service Revenues. *See* Staff Ex. 7.0, Sch. 7.01 AC, Col. (i), ll. 23, 22, 21, 20, 3, 2, and 1. Considering the way Staff's revenue requirement determines proposed Water Service Revenues, the increase in Miscellaneous Revenues that results from the New Customer Charge adjustment is NOT negated in the manner described by the Intervenor.

Cursory review of the revenue requirements attached to Staff's direct testimony, Staff Ex. 1.0, Sch. 1.01 AC and LW, and the revenue requirements attached to the Companies' rebuttal testimony, Utilities Ex. 2.0, Sch. 2.1 AC and LW, reveals that the Companies' rebuttal revenue requirements are based entirely on Staff's revenue requirements.[2] The agreed-upon adjustment to revenue for the New Customer Charge is set forth within the Companies' rebuttal (and, effectively, surrebuttal) revenue requirements identically to that set forth in Staff's revenue requirements. Thus, Staff took no issue with the Companies' presentation of this adjustment. The Commission should accept this adjustment as proposed by Staff and agreed-to by the Companies.

<u>Revenues Associated with HomeServe USA Service Plans</u>

Staff proposed adjustments for each utility to include compensation received from HomeServe USA as a result of ratepayers from each utility enrolling in HomeServe USA service repair plans in Miscellaneous Revenues. Staff Ex. 3.0 at 17. The Companies stated that they accepted the Staff adjustments. Utilities Ex. 2.0 at 10. However, the Intervenors took issue with the way the Companies reflected the agreed-to adjustments in the Companies' rebuttal exhibits, arguing that the Companies' methodology negates the agreed-to adjustment. AG/ACLPOA/LWA Joint Ex. 2.0 at 2-4. As similarly discussed in the section above, the Intervenors' concerns should be dismissed, as those concerns are based on what appears to be a misunderstanding of the mechanics of Staff's revenue requirement. Considering the way Staff's revenue requirement determines proposed Water Service Revenues, the increase in Miscellaneous Revenues that results from the HomeServe USA adjustment is NOT negated in the manner described by the Intervenor.

The agreed-upon adjustment to revenue for the Revenues Associated with HomeServe USA Service Plans is set forth within the Companies' rebuttal (and,

[2] A similar conclusion can be reached regarding the Companies' surrebuttal revenue requirements, Utilities Ex. 3, Sch. 3.1 AC and LW, as compared to Staff's rebuttal revenue requirements. Staff Ex. 7.0, Sch. 7.01 AC and LW.

effectively, surrebuttal) revenue requirements identically to that set forth in Staff's revenue requirements. Thus, Staff took no issue with the Companies' presentation of this adjustment. The Commission should accept this adjustment as proposed by Staff and agreed-to by the Companies.

401(k) Matching Contributions

The Intervenors proposed an adjustment to reduce 401(k) Plan Expense to reflect actual employee participation in the Companies' 401(k) matching plans. AG/ACLPOA/LWA Joint Ex. 1.0 at 25-27. The Companies did not oppose the adjustment proposed by the Intervenors. Utilities Ex. 2.0 at 11. Staff also agreed with the Intervenor adjustment. Staff Ex. 9.0 at 13.

Contested Issues

Appeals Costs

The Commission should adopt the Staff and Intervenor adjustments to remove the appeals costs related to the Companies' 2009 rate cases from operating expenses for each utility. These costs are above and beyond what was approved as rate case expense by the Commission in those proceedings, and do not represent normal costs of doing business that are expected to recur during the periods in which rates set in this proceeding will be in effect. Further, ratepayers should not be forced to compensate the Companies for costs of actions they undertook as a result of their dissatisfaction with the Commission's Order. Staff Ex. 9.0 at 4-7.

The Companies took exception to the Staff and Intervenor adjustments to remove appeals costs, setting forth various arguments in rebuttal and surrebuttal testimony. The Companies' arguments should be dismissed.

The Companies argued that the appeals costs should be allowed because the Companies were not the first party to initiate the appeal, that legal costs associated with an appeal represent a normal and legitimate cost of doing business, and that the public is served by the development of precedent that guides future proceedings at the Commission. Utilities Ex. 2.0 at 11-12. Further, the Companies argue that they could not have included the cost of appeals in the 2009 rate case expense because it was not yet known and measurable, that the Companies have the right to defend their positions in court and the right to seek guidance from the court regarding proper application of the Public Utilities Act, and that the non-recurring nature of these expenses should not be a reason to not allow the Companies to recover "legitimate" business expenses. Utilities Ex. 3.0 at 8-9. However, the Companies fail to consider that it is not appropriate for all costs – whether they are legitimate or not – to be recovered from ratepayers.

The Companies spent amounts well in excess of the approved rate case expense amounts in their 2009 rate cases even before appeals; thus, the appeals costs incurred in 2011 are also in excess of the previously approved rate case expense amounts.[3] Further, ratepayers should not be forced to compensate Companies for the costs of appeals. Staff Ex. 3.0 at 9-10. Such an arrangement would give utilities an incentive to incur costs for appeals of Commission decisions during test years of future rate proceedings without regard to the costs for such actions because the utilities would be allowed recovery of such costs from ratepayers, while the Company'shareholders provide no funding of the appeals. Utilities must assess the potential costs of an appeal

[3] Apple Canyon spent $186,393 on the 2009 rate case (before appeals), but was approved for only $94,107. Lake Wildwood spent $171,063 on the 2009 rate case (before appeals), but was approved for only $90,573. Thus, appeals costs incurred after those rate cases are also in excess of the approved amounts. Staff Ex. 3.0 at 9-10.

versus the benefits that might be obtained from a successful appeal, and weigh those costs and benefits with the likelihood that the appeal will be successful. If appeals costs are allowed to be recovered from ratepayers, then utilities will have no reason to weigh those costs and benefits with the likelihood of success of the appeal. This could presumably result in an appeal for every Commission decision with which utilities disagree. Ultimately, such an arrangement could have the effect of shifting ratemaking authority from the Commission to the appellate courts. Staff Ex. 9.0 at 6-7.

In addition, while the legal costs associated with a utility's appeals *may* represent a legitimate cost of doing business, the costs at issue in these proceedings do not represent *normal* costs of doing business. The appeals costs at issue here do not represent normal costs that will be incurred every year. Normal costs are those that conform to a type, standard, or regular pattern.[4] Normal costs can be expected to be incurred at a routine and predictable frequency and amount. The Companies have not submitted any evidence that supports a claim that the costs of appeals represent normal costs of doing business for these specific utilities. In fact, going back to as early as 2000, encompassing twenty-three separately filed UI general rate cases prior to the current proceedings and including two general rate cases each for Apple Canyon and Lake Wildwood, the only appeals that occurred relate to the 2009 proceedings at issue here. As such, costs associated with the 2009 rate case appeals do not represent normal costs. Staff Ex. 9.0 at 5-6.

Finally, the appeals costs in question are non-recurring costs incurred during the test year that are not reasonably expected to recur during the period in which rates

[4] "Normal" *Merriam-Webster.com*. 2013. http://www.merriam-webster.com. (21 March 2013).

determined in the current proceeding will be in effect.[5] Consequently, these non-recurring costs should be removed as a known and measurable adjustment to the test year. AG/ACLPOA/LWA Joint Ex. 1.0 at 19-21.

Alternative Proposals for Appeals Costs

The Commission should adopt the adjustments set forth by Staff and the Intervenors, and disallow appeals costs related to the Companies' 2009 rate cases. However, if the Commission rejects Staff's primary position, Staff recommends that the Commission allow recovery of 50% of *appropriately supported*[6] appeals costs, deferred and amortized over the same five-year amortization period that the Companies and Staff are recommending for the rate case expenses of the current proceeding. Staff Ex. 9.0 at 8.

As described in the March 5, 2013 appellate court opinion and discussed briefly above, there were essentially four issues on appeal – two issues appealed by the Intervenors and two issues appealed by the Companies. As such, one could conclude that two of the four appeals issues were not initiated by the Companies and costs incurred related to defending the Companies on those issues could be recoverable. Staff's alternative adjustment would allow deferral and amortization of 50% of 2011 appeals costs (2 issues / 4 issues = 50%). Staff Ex. 9.0 at 8-9. Pages 4 and 5 of Staff

[5] In fact, appellate arguments are already complete. The appellate court issued its ruling on the appeals in question in March of 2013. See *Apple Canyon Lake Prop. Owners' Ass'n v. Ill. Commerce Comm'n*, Nos. 3-10-0832, 3-10-0898 (cons.) (Ill. App. Mar. 5, 2013).

[6] If any portion of the costs of rate case appeals are allowed, they should be allowed only to the extent that they are supported by sufficient documentation in the record and are subject to the same scrutiny as other rate case expenses under Section 9-229 of the Public Utilities Act. 220 ILCS 5/9-229. The Companies provided support for the appeals costs in question within UtilitiesEx. 3.3. Staff believes that the support provided in UtilitiesEx. 3.3 is of a type that could allow the Commission to reach the necessary conclusions required by Section 9-229 of the Act regarding the justness and reasonableness of amounts expended to compensate attorneys for work on the appeals

Cross Ex. 2 set forth the adjustment necessary to implement this alternative adjustment. For Apple Canyon, the alternative amortized appeals costs to be included in the revenue requirement would be $1,986. Staff Cross Ex. 2 at 4. For Lake Wildwood, the alternative amortized appeals costs to be included in the revenue requirement would be $2,017. *Id.* at 5.

IV. ADDITIONAL ACCOUNTING RECOMMENDATIONS

<u>Accounting for Disallowed Plant</u>

Staff witness Ebrey recommended that the Companies be ordered to:

1) Record adjusting journal entries to remove all plant that has been disallowed in prior orders; and
2) File the actual journal entries made to record all retirements addressed and approved in the Final Order of these proceedings and prior rate cases that had not yet been recorded on e-docket within 60 days of the Final Orders in these rate cases and provide a copy to the Manager of Accounting. Staff Ex. 8.0 at 8.

The Companies accepted these recommendations. Utilities Ex. 3.0 at 7.

<u>Original Cost Determination</u>

Staff recommends that the Commission Order in this proceeding state:

> It is further ordered that the $2,882,956 original cost of water plant in service for Apple Canyon Utility Company at December 31, 2011, as reflected on Staff Schedule 8.07, is unconditionally approved as the water original costs of plant.
>
> It is further ordered that the $1,504,265 original cost of water plant in service for Lake Wildwood Utilities Corporation at December 31, 2011, as reflected on Staff Schedule 8.07, is unconditionally approved as the water original costs of plant.

These amounts would need to be revised to reflect any changes to historic plant that are approved in the Final Order that differ from my recommendations for plant. Staff Ex. 8.0 at 7. The Companies agree. Utilities Ex. 3.0 at 6.

V. RATE OF RETURN

Staff witness Freetly presented the overall cost of capital and recommended a fair rate of return on rate base for Apple Canyon and Lake Wildwood. Staff Ex. 5.0. The Companies accepted Staff's 7.95% overall cost of capital recommendation. Utilities Ex. 2.0 at 16-17; Schedules 2.1AC and 2.1LW.

Weighted Average Cost of Capital
December 31, 2011

Staff Proposal

	Amount	Percent of Total Capital	Cost	Weighted Cost
Long-term Debt	$178,726,842	50.24%	6.66%	3.35%
Common Equity	$177,007,000	49.76%	9.25%	4.60%
Total Capital	$355,733,842	100.00%		
Weighted Average Cost of Capital				**7.95%**

a. Capital Structure

Since the Companies are wholly owned subsidiaries of UI, Staff proposed using UI's capital structure for the year ended December 31, 2011, comprised of 50.24% long-term debt, and 49.76% common equity. Staff Ex. 5.0 at 3, Schedule 5.1.

Ms. Freetly adjusted the $180,000,000 balance of long-term debt outstanding on December 31, 2011 to reflect the unamortized debt expense incurred to issue the debt, which produces a long-term debt balance of $178,726,842. Staff Ex. 5.0 at 4, Schedule 5.2.

Ms. Freetly used the $177,007,000 balance of common shareholders equity on December 31, 2011 from the Consolidated Financial Statements of Utilities, Inc. provided in response to Staff Data Request (“DR”) JF-1.09. Staff Ex. 5.0 at 4.

Ms. Freetly did not adjust the long-term capital components to recognize the Commission’s formula for calculating AFUDC because UI’s capital structure does not contain any short-term debt. When the balance of short-term debt is zero, this adjustment does not affect the capital structure ratios. *Id.*

b. Cost of Debt

The Companies’ embedded cost of long-term debt is 6.66%, which includes the annual amortization of debt expense to reflect straight line amortization of the unamortized balance over the remaining life of the outstanding issue of long-term debt. *Id.* at 6-7, Schedule 5.2.

c. Cost of Common Equity

Ms. Freetly recommended a 9.25% cost of common equity for UI subsidiaries Apple Canyon and Lake Wildwood. She measured the investor-required rate of return on common equity for UI with the discounted cash flow (“DCF”) and risk premium models. DCF and risk premium models cannot be directly applied to UI because its stock is not market traded. Therefore, Ms. Freetly applied those models to water utility and public utility samples (hereafter, referred to as "Water sample" and "Utility sample," respectively).

Staff's Water sample consists of domestic corporations classified as water utilities within Standard & Poor's ("S&P") *Utility Compustat II* that have publicly traded common stock and the data needed to perform the cost of equity analysis. *Id.* at 7-8. To form the Utility sample, Staff began with a list of all domestic dividend paying publicly-traded corporations assigned an industry number of 4911, 4922, 4923, 4924, 4931 or 4932 in the S&P *Utility Compustat II* data base that have been assigned (1) an S&P credit rating of BBB or BBB-; (2) an S&P business risk profile score of "excellent"; and (3) S&P financial risk profile of "intermediate," "significant," or "aggressive." Companies that did not have the data needed to perform the cost of equity analysis or were in the process of being acquired by another company or acquiring a company or similar size were not included in the Utility sample. *Id.* at 8-11.

1. DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments to the holders of that stock. Ms. Freetly employed a non-constant-growth DCF ("NCDCF") model that reflects a quarterly frequency in dividend payments. *Id.* at 11-20.

Ms. Freetly implemented the NCDCF model in this proceeding because the level of growth indicated by the average 3-5 year growth rates for her Water sample are not sustainable over the long-term. The average 3-5 year growth rate was 5.73% for the Water sample and 4.74% for the Utility sample, while Staff's estimate of the long-term growth rate was 4.86%. Since the near-term growth rates for the Water sample exceeds the expected long-term overall economic growth rate, the sustainability of the average 3-5 year growth rates for the Water sample is unlikely. Further, Staff calculated the return on equity ("ROE") implied by the 3-5 year growth rates, based on the dividend payout and other data published in Value Line for each company in the Water and Utility samples. That calculation produced an average ROE of 15.06% for the Water sample and 12.96% for the Utility sample. In comparison, Value Line forecasts an implied average ROE for the 2014-2016 period of 10.80% for the Water sample and 9.55% for the Utility sample. Hence, it is unlikely that investors expect the sample companies to sustain a 15.06% or 12.96% rate of return on equity indefinitely. Consequently, Ms. Freetly implemented a multi-stage NCDCF analysis. *Id.* at 13-15.

Staff witness Freetly modeled three stages of dividend growth. For the first five years, Ms. Freetly used market-consensus expected growth rates published by Zacks and Reuters as of December 19, 2012. For the second stage, a transitional growth period that spans from the beginning of the sixth year through the end of the tenth year, Ms. Freetly used the average of the first- and third-stage growth rates. Finally, for the third, or "steady-state," growth stage, which commences at the end of the tenth year and is assumed to last into perpetuity, Ms. Freetly calculated a 4.86% expected long-term nominal overall economic growth rate beginning in 2021; that growth rate was calculated using the expected real growth rate (2.5%) based on the average of the Energy Information Administration's ("EIA") and Global Insight's long-term forecasts of real gross domestic product ("GDP"), and the expected inflation rate (2.6%) based on the difference between yields on U.S. Treasury bonds and U.S. Treasury Inflation-Protected Securities. She then combined the resulting 5.2% growth estimate with the

4.7% average nominal economic growth forecasted by EIA and Global Insight. *Id.* at 14-17.

The growth rate estimates were combined with the closing stock prices and dividend data as of December 19, 2012. Based on these growth assumptions, stock price, and dividend data, Ms. Freetly's DCF estimate of the cost of common equity was 8.71% for the Water sample and 9.07% for the Utility sample. *Id.* at 19-20, Schedule 5.7.

2. Risk Premium Analysis

According to financial theory, the required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. Staff witness Freetly used a one-factor risk premium model, the Capital Asset Pricing Model ("CAPM"), to estimate the cost of common equity. *Id.* at 20-33.

The CAPM requires the estimation of three parameters: beta, the risk-free rate, and the required rate of return on the market. For the beta parameter, Ms. Freetly combined adjusted betas from Value Line, Zacks, and a regression analysis to estimate the beta of the Water and Utility sample. For the Water sample, the average Value Line, Zacks, and regression beta estimates were 0.66, 0.58, and 0.55, respectively. For the Utility sample, the average Value Line, Zacks, and regression beta estimates were 0.71, 0.73, and 0.68, respectively. The Value Line regression employs weekly observations of stock return data while both the regression beta and Zacks betas employ monthly observations. Since the Zacks beta estimate and the regression beta estimate are calculated using monthly data rather than weekly data (as Value Line uses), Ms. Freetly averaged those results to avoid over-weighting betas estimated from monthly data in comparison to the weekly data-derived Value Line betas. She then averaged the resulting monthly beta with the Value Line weekly beta, which produced a beta of 0.61 for the Water sample and 0.71 for the Utility sample. *Id.* at 27-32.

For the risk-free rate parameter, Ms. Freetly considered the 0.03% yield on four-week U.S. Treasury bills and the 3.01% yield on thirty-year U.S. Treasury bonds. Both estimates were measured as of December 19, 2012. Forecasts of long-term inflation and the real risk-free rate imply that the long-term risk-free rate is between 4.3% and 4.9%. Thus, Ms. Freetly concluded that the U.S. T-bond yield is currently the superior proxy for the long-term risk-free rate. *Id.* at 21-26.

Finally, for the expected rate of return on the market parameter, Ms. Freetly conducted a DCF analysis on the firms composing the S&P 500 Index. That analysis estimated that the expected rate of return on the market was 12.81% for the third quarter of 2012. *Id*. at 26-27. Inputting those three parameters into the CAPM, Ms. Freetly calculated a cost of common equity estimate of 8.99% for the Water sample and 9.97% for the Utility sample. *Id.* at 33, Schedule 5.8.

3. Staff Cost of Equity Recommendation

First, Ms. Freetly estimated the investor-required rate of return on common equity for the two samples from the results of the DCF and risk premium analyses for the samples. The average investor-required rate of return on common equity for the Water sample, 8.85%, is based on the average of the DCF-derived results (8.71%) and the risk-premium derived results (8.99%) for the Water sample. The average investor-required rate of return on common equity for the Utility sample, 9.52%, is based on the average of the DCF-derived results (9.07%) and the risk-premium derived results (9.97%) for the Utility sample. *Id.* at 34.

To assess relative financial risk, Ms. Freetly estimated the credit ratings implied by the key credit metrics that Moody's Investors Service ("Moody's") publishes for global regulated water utilities and regulated electric and gas utilities. Ms. Freetly compared three-year average financial ratios for UI and the Water sample to Moody's key credit metrics for global regulated water utilities. She compared the three-year average financial ratios for the Utility sample to Moody's key credit metrics for regulated electric and gas utilities. This analysis revealed that the financial ratios for UI are commensurate with a Baa2 rating, while the financial ratios are indicative of a level of financial risk that is commensurate with a Baa1 credit rating for the Water sample and a credit Baa2 rating for the Utility sample. The samples' implied credit ratings indicate that the Water sample has slightly less financial risk than UI and the Utility sample has slightly more financial risk than UI. Given the small difference between the implied credit rating of UI and the implied credit ratings of the Water sample, in Ms. Freetly's judgment, the cost of common equity for the Companies should be derived giving slightly less weight to the cost of common equity for the Water sample. Thus, she assigned 40% weighting to the 8.85% cost of common equity for the Water sample and 60% weighting to the 9.51% cost of common equity for the Utility sample to derive an appropriate estimate of the Companies' costs of common equity of 9.25%. *Id.* at 35-38.

VI. RATES AND COST OF SERVICE ("COS") STUDIES

Staff and the Companies agreed to (1) maintain the current customer classes; (2) accept UI's proposed billing units; (3) increase the New Customer Charge from $15 to $25, which resulted in an adjustment to Miscellaneous Revenues for Apple Canyon and Lake Wildwood; and (4) place the Availability customers on a monthly billing cycle and to provide consistent tariff language in that regard. Staff Ex. 4.0 at 4, 8, 24; Staff Ex. 10.0 at 11-12.

Staff recommends the Commission accept Staff's proposed rate designs for the Companies, which are based on COS studies. Designing cost-based rates is one of the goals and objectives of regulation. Staff Ex. 10.0 at 6; 220 ILCS 5/1-102. Staff's proposed rate designs better reflect cost causation than do the Companies' proposed rate designs, which have no cost foundation. Staff Ex. 4.0 at 19; Staff Ex. 10.0 at 4-5. Furthermore, Staff's proposed rate designs are consistent with the Commission's direction in Consolidated Docket Nos. 11-0561-11-0566 where the Commission stated:

> The Commission orders UI to work with Staff and other interested parties to review and analyze UI's current method of cost of service and rate design methodology. UI should develop a COSS with Staff and other interested parties for use in future UI rate cases.

Final Order at 27, Proposed increase in water and sewer rates, Docket Nos. 11-0561-11-0566 (Cons.) (May 22, 2012).

For Lake Wildwood, Staff recommended that rates be set at full COS. Staff Ex. 4.0 at 20; Staff Ex. 10.0 at 9. For Apple Canyon, Staff recommended that the 5/8" meter and 3/4" meter Base Facility Charges ("BFC") remain at their present rates because the COS study results showed a COS below the present BFC.[7] Staff Ex. 10.0 at 8. UI witness Neyzelman agreed that the BFCs should not be decreased from current effective rates. Utilities Ex. 3.0 at 11; *Tr.,* April 15, 2013, at 37. Staff also recommended the 1" meter BFC be set exactly at full COS. Finally, Staff recommended the BFCs for the 1½" meter, 2" meter and 3" meter all increase by 25% of the difference

[7] The COS for each meter size is shown on the far right column on the top half of page 1 of Staff Ex. 10.0, Schedule 10.1 AC.

between full COS and current rates. These three meter sizes would all reflect increases from 135% to over 500% if moved to full COS; thus, Staff recommended only increasing rates incrementally toward full COS in this proceeding. Staff Ex. 10.0 at 8.

Staff recommends the Commission reject all BFC and usage charge rates that have been proposed by UI. The Companies initially proposed a flat percentage increase across-the-board in direct testimony, but in rebuttal testimony proposed, in the alternative, to set rates by modeling after a previous Commission-approved rate design in Consolidated Docket Nos. 11-0561 through 11-0566. Utilities Ex. 1.0 at 6-7; Utilities Ex. 2.0 at 15; Staff Cross Ex. 1. Neither of the Companies' proposed rates are based on cost causation. Companies' witness Neyzelman agreed that a COS study would assign costs based on cost causation. Utilities Ex. 2.0 at 15; Utilities Ex. 3.0 at 11. The Companies throughout this case have had ample opportunity to evaluate and propose changes to Staff's COS studies. They have chosen not to do so, despite a previous Commission Order in Consolidated Docket Nos. 11-0561-11-0566 directing UI to work with Staff and other interested parties to develop a COS study for use in future UI rate cases. Staff Ex. 10 at 5.

Despite being given ample opportunity to address Staff's COS studies in its direct, rebuttal, and surrebuttal testimony and as responses to specific Staff DRs for information, the Companies have refused to explain its "misgivings" with respect to Staff's COS study-based approach. UI witness Neyzelman's rebuttal and surrebuttal testimonies stated that he disagreed with certain allocations of costs assigned by Staff in its COS study. Utilities Ex. 2.0 at 15; Utilities Ex. 3.0 at 11. Staff Cross Exhibit 1.0 shows UI's responses to Staff's DRs asking UI to identify and explain the basis for these concerns. UI responded that "[t]he Companies are currently investigating the COS Study in detail and will provide a response as soon as possible." Staff Cross Ex. 1.0. However, no further response was received from the Companies. Under cross-examination, UI witness Neyzelman consistently stated that he is not a COS study expert, and therefore, he can not explain the allocation factor problems that he briefly noted in testimony, though he did not list any specific allocation factor problems. *Tr.,* April 15, 2013, at 38, 43, 46, 49.

The model Staff used for its COS studies is not new and has been used in some of the Companies' previous rate cases. For example, this COS study format was approved for Lake Wildwood in two prior rate cases: Docket Nos. 98-0048 and 01-0663. Staff Ex. 4.0 at 11-12. Also, in Apple Canyon Docket No. 03-0399, "[s]taff advocated across-the-board increases as the only reasonable approach for base rates, even though the across-the–board approach diverges from <u>the standard Commission policy of basing rates on cost</u>. Staff did not recommend a cost-based approach because Staff believed the information provided by the Companies was not sufficient to run its cost-of-service study." Final Order at 16, <u>Proposed general increase in water and sewer rates</u>, Docket Nos. 03-0398-03-0402 (Cons.) (April 7, 2004) (emphasis added). In the current cases, the Companies were able to provide the necessary data for Staff to run its COS studies and Staff has done so. Staff Ex. 4.0 at 12. Nonetheless, the fact that the Companies were unable to provide sufficient information for Staff to run its COS studies in some of their prior cases does not preclude Staff from presenting the COS studies in these cases where Staff does have the information. Staff's witness has the technical expertise and experience to perform COS studies, even if the Companies' witness does not. *Tr.,* April 15, 2013, at 38, 43, 46, 49.

The Companies next argue that if the Commission does use Staff's COS studies, then all the rates should be set at full cost. UI witness Neyzelman stated in his surrebuttal testimony: "[i]f the Commission does approve Staff's recommended COS Study, then the rates that the COS Study produces should be used without an arbitrary shift of revenues from the fixed component to the variable component." Utilities Ex. 3.0 at 12.

Staff did recommend that Lake Wildwood rates be set at full COS in direct and rebuttal testimony. Staff Ex. 4.0 at 20; Staff Ex. 10.0 at 9. However, if Apple Canyon rates were set at full COS for the various BFCs that are based on American Water Works Association "AWWA" meter flow factors, without reducing any present BFCs, the total revenue from the BFCs and availability charge would be $452,069. After subtracting non-metered revenues from Staff's recommended revenue requirement, $52,999 would be remaining for the usage charge revenues. Using the agreed billing units of 19,958,the usage charge would need to be reduced significantly below its current level to prevent the Company from over recovering its revenue requirement. For example, the usage charge would have to decrease from the current rate of 5.7041 cents per kwh to 2.6555 cents per kwh using Staff's revenue requirement. ($52,999/19,958= $2.65 cents) For all these reasons, the Commission should accept Staff's proposed rate designs for the Companies.

VII. MISCELLANEOUS

Rules, Regulation, and Conditions of Service Tariffs

Apple Canyon proposed changes to its current Rules, Regulations, and Conditions of Service tariffs for water service ("Rules") to include the addition of a sample bill and the movement of the Unaccounted-for Water tariff sheet from the Rules to the Schedule of Rates for Water Service. Apple Canyon Ex. 1.0 at 9. Staff witness Smith recommended a language change to the description of the applicable territory of the proposed Rules. Staff Ex. 6.0 at 3. Apple Canyon agreed with Staff's recommended changes to the proposed Rules, and provided updated Rules reflecting Staff's recommended changes as Utilities Ex. 2.2. Utilities Ex. 2.0 at 16; *see* Utilities Ex. 2.2.

Similarly, Lake Wildwood proposed changes to its current Rules to include the addition of a sample bill and the movement of the Unaccounted-for Water tariff sheet from the Rules to the Schedule of Rates for Water Service. Lake Wildwood Ex. 1.0 at 9. Staff witness Smith recommended a language change to the description of the applicable territory of the proposed Rules. Staff Ex. 6.0 at 4. Lake Wildwood agreed with Staff's recommended changes to the proposed Rules and provided updated Rules reflecting Staff's recommended changes as Utilities Ex. 2.2. Utilities Ex. 2.0 at 16.

Conclusion

WHEREFORE, the Staff of the Illinois Commerce Commission respectfully requests that its recommendations be adopted in their entirety consistent with the arguments set forth herein.

Respectfully submitted,

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